



Roth IRA Conversions

Robert S. Keebler, CPA/PFS, MST, AEP
Keebler & Associates, LLP

Taxation of Roth IRA Conversions

TAX REFORM REPEALED THE ABILITY TO RECHARACTERIZE A ROTH CONVERSION

Mathematics of Roth IRA Conversions

- In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that:
 - The annual growth rates are the same
 - The tax rate in the conversion year is the same as the tax rate during the withdrawal years (i.e. $A \times B \times C = D$; $A \times C \times B = D$)

Mathematics of Roth IRA Conversions

	Traditional IRA	Roth IRA
Current Account Balance	\$ 1,000,000	\$ 1,000,000
Less: Income Taxes @ 40%	-	(400,000)
Net Balance	\$ 1,000,000	\$ 600,000
 Growth Until Death	 200.00%	 200.00%
Account Balance @ Death	\$ 3,000,000	\$ 1,800,000
Less: Income Taxes @ 40%	(1,200,000)	-
Net Account Balance to Family	\$ 1,800,000	\$ 1,800,000

Mathematics of Roth IRA Conversions

- Critical decisions factors
 - Tax rate differential (year of conversion vs. withdrawal years)
 - Use of “outside funds” to pay the income tax liability
 - Need for IRA funds to meet annual living expenses
 - Time horizon

Mathematics of Roth IRA Conversions

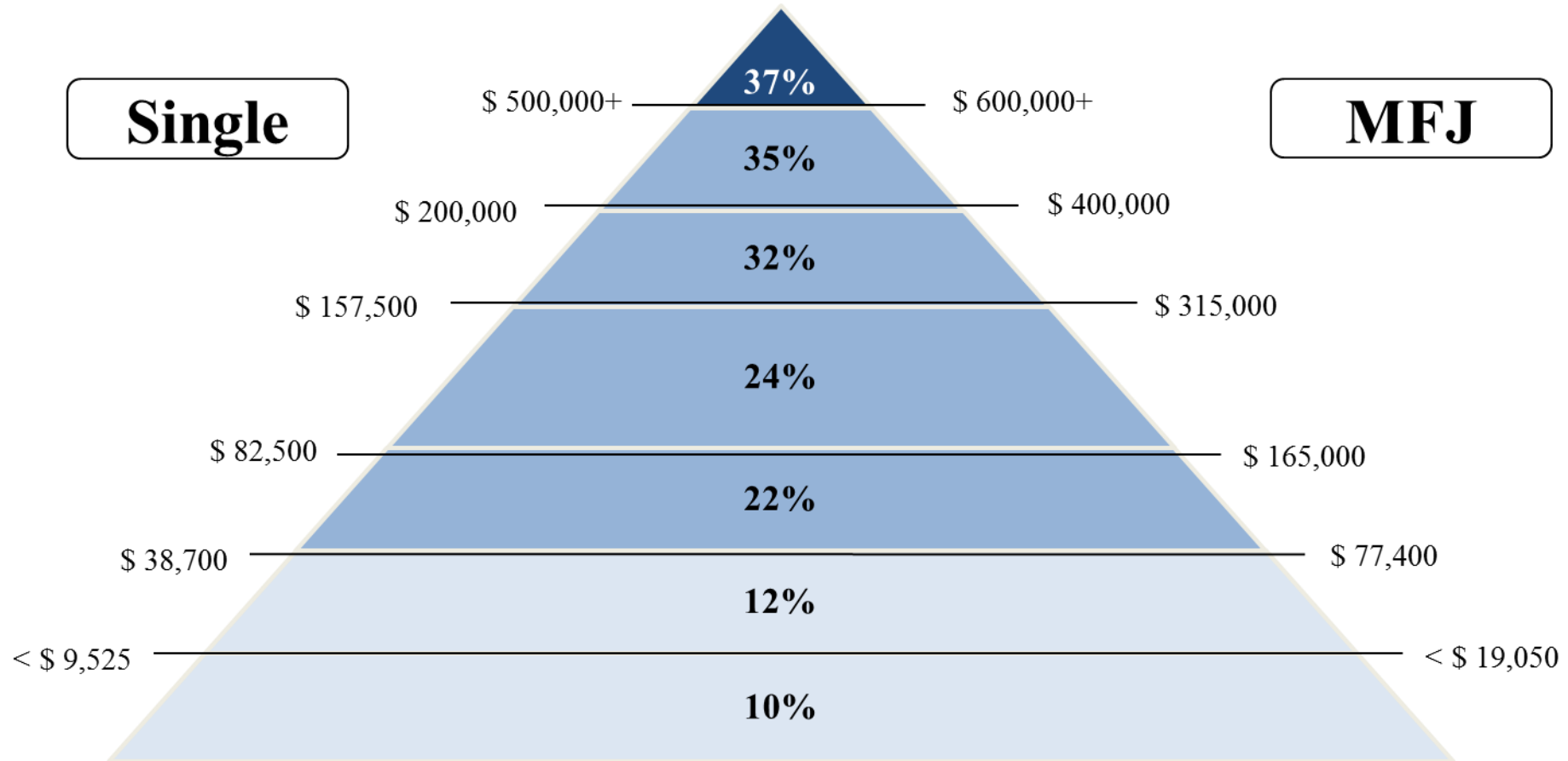
- The key to successful Roth IRA conversions is to keep as much of the conversion income as possible in the current marginal tax bracket
 - However, there are times when it may make sense to convert more and go into higher tax brackets
 - Need to take into consideration the new 3.8% Medicare “surtax”
 - Need to take into consideration the impact of AMT

Mathematics of Roth IRA Conversions

2018 Income Tax Brackets

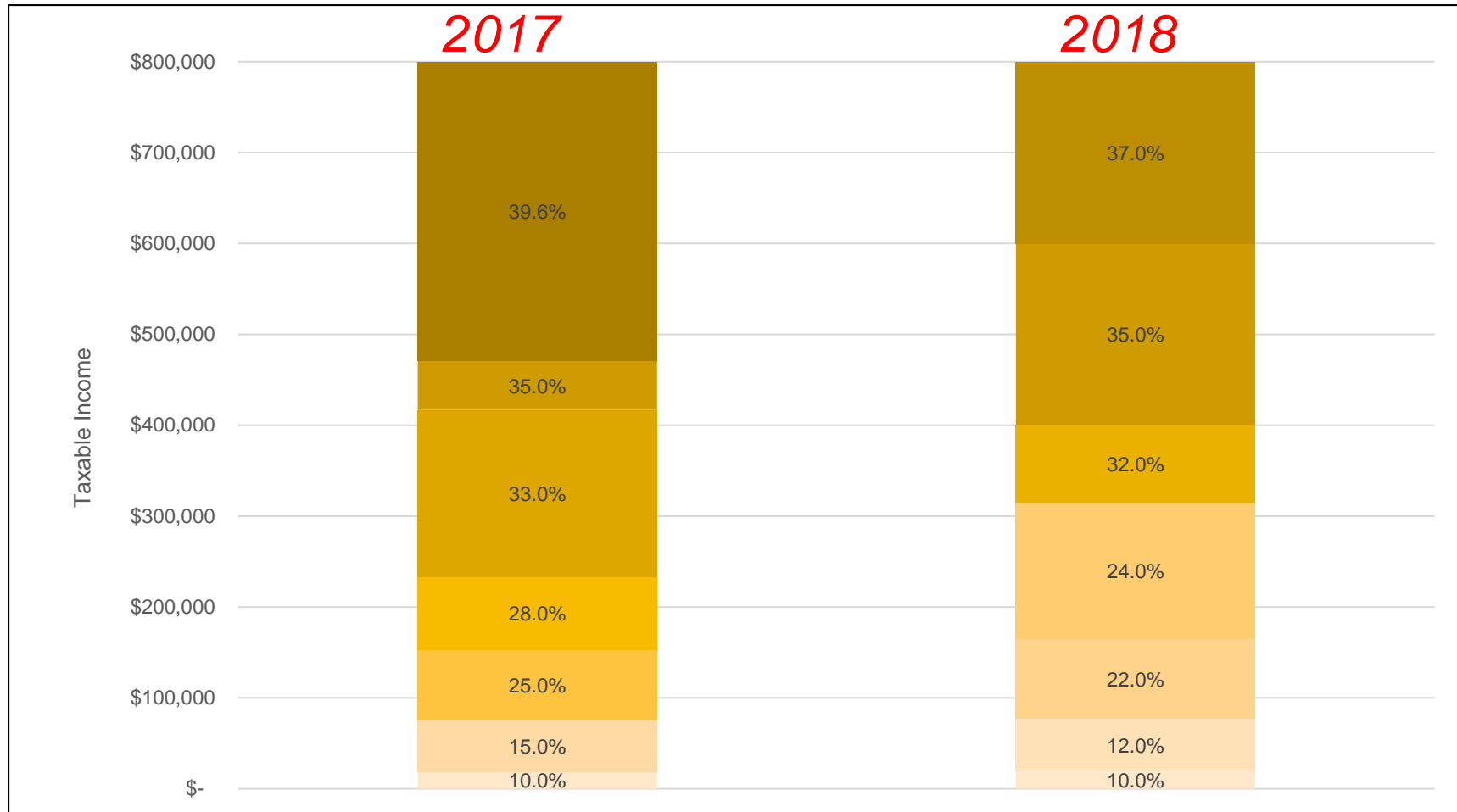
	Single	Married Filing Jointly	Married Filing Separately	Head of Household
10%	\$9,525	\$19,050	\$9,525	\$13,600
12%	\$38,700	\$77,400	\$38,700	\$51,800
22%	\$82,500	\$165,000	\$82,500	\$82,500
24%	\$157,500	\$315,000	\$157,500	\$157,500
32%	\$200,000	\$400,000	\$200,000	\$200,000
35%	\$500,000	\$600,000	\$300,000	\$500,000
37%	>\$500,000	>\$600,000	>\$300,000	>\$500,000

Individual Income Tax Rates

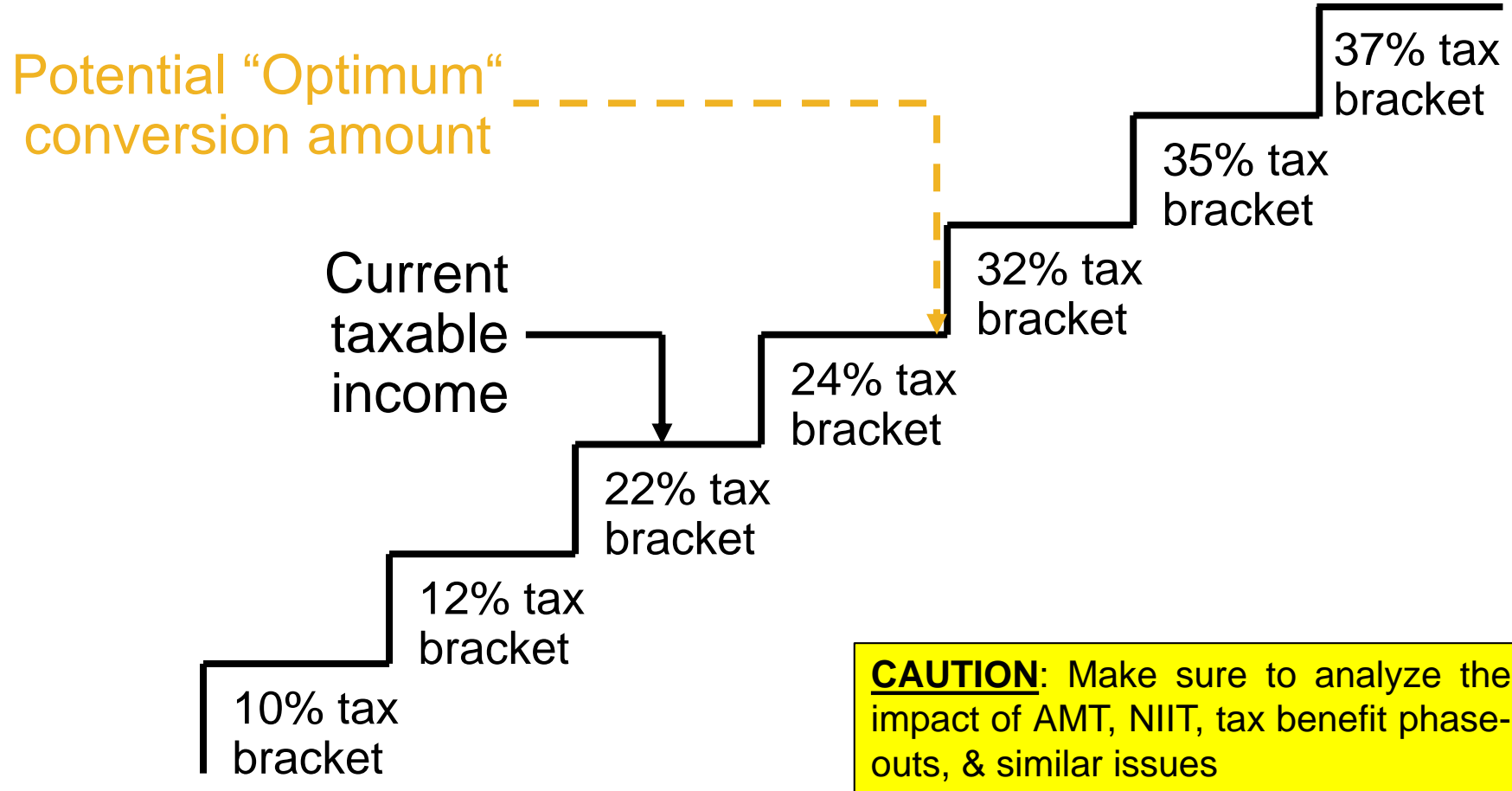


All figures are taxable income

Individual Income Tax Rates (MFJ) Comparison

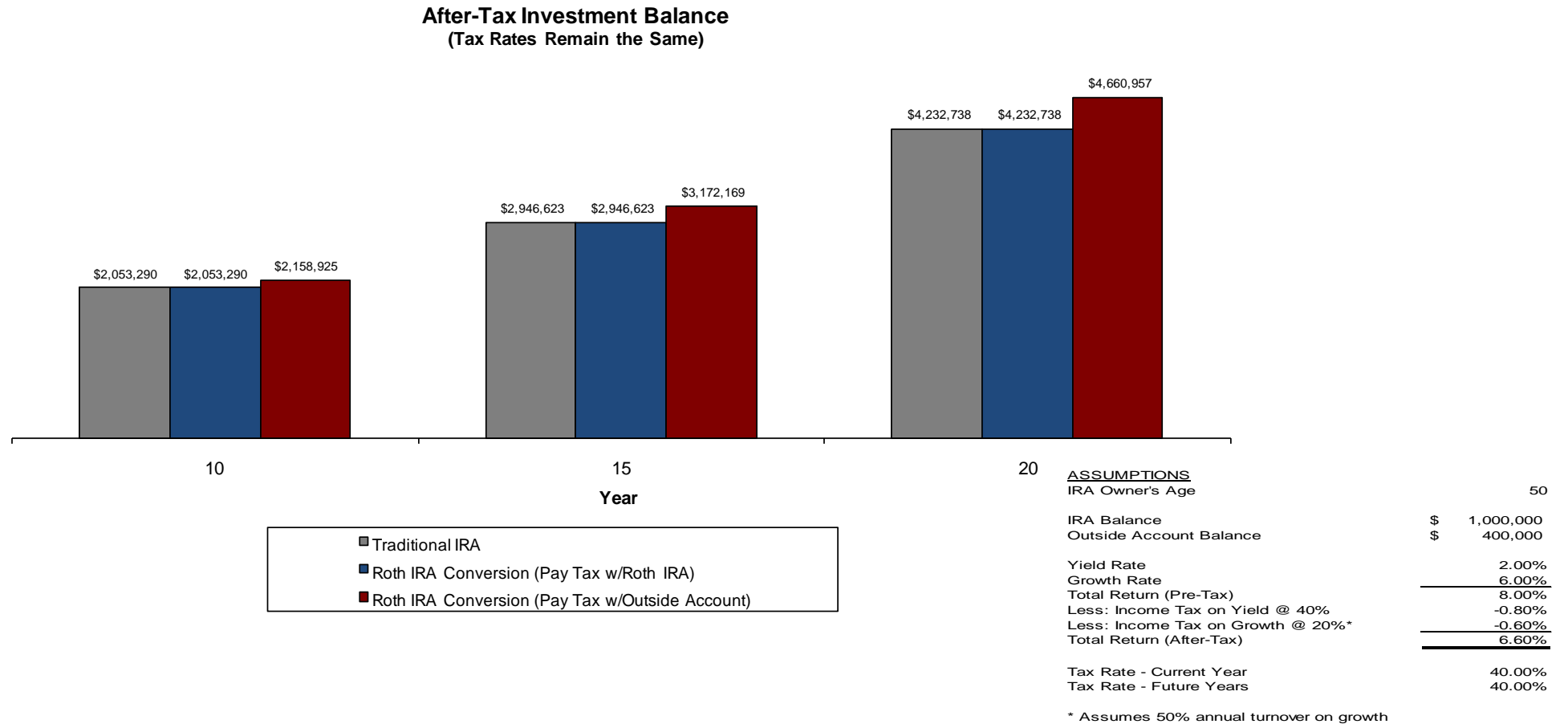


Mathematics of Roth IRA Conversions



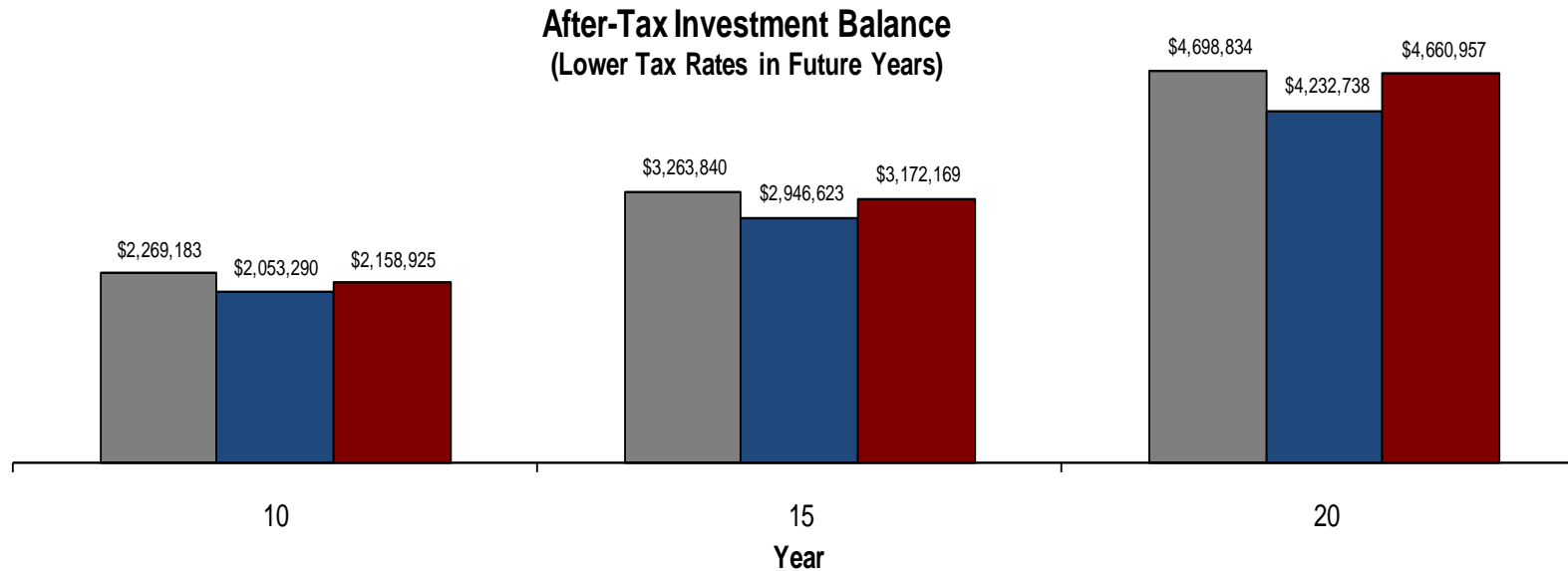
Mathematics of Roth IRA Conversions

Example #1 – 50 Year-Old IRA Owner



Mathematics of Roth IRA Conversions

Example #2 – 50 Year-Old IRA Owner



Traditional IRA
 Roth IRA Conversion (Pay Tax w/Roth IRA)
 Roth IRA Conversion (Pay Tax w/Outside Account)

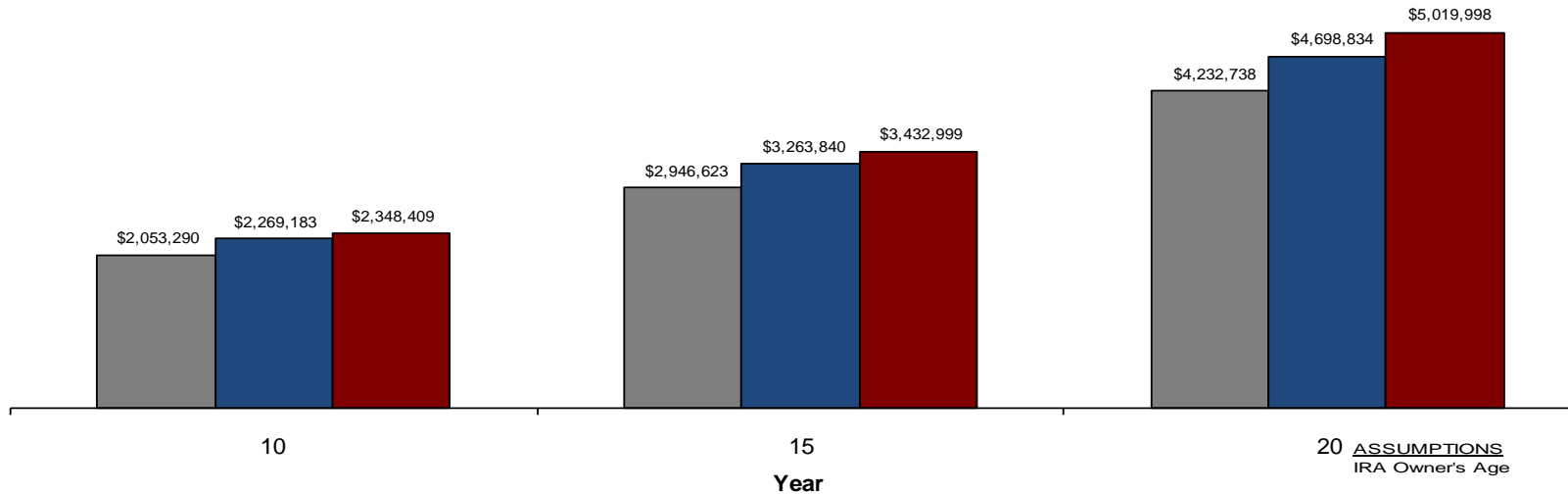
<u>ASSUMPTIONS</u>	
IRA Owner's Age	50
IRA Balance	\$ 1,000,000
Outside Account Balance	\$ 400,000
Yield Rate	2.00%
Growth Rate	6.00%
Total Return (Pre-Tax)	8.00%
Less: Income Tax on Yield @ 40%	-0.80%
Less: Income Tax on Growth @ 20%*	-0.60%
Total Return (After-Tax)	6.60%
Tax Rate - Current Year	40.00%
Tax Rate - Future Years	30.00%

* Assumes 50% annual turnover on growth

Mathematics of Roth IRA Conversions

Example #3 – 50 Year-Old IRA Owner

After-Tax Investment Balance
(Higher Tax Rates in Future Years)



- Traditional IRA
- Roth IRA Conversion (Pay Tax w/Roth IRA)
- Roth IRA Conversion (Pay Tax w/Outside Account)

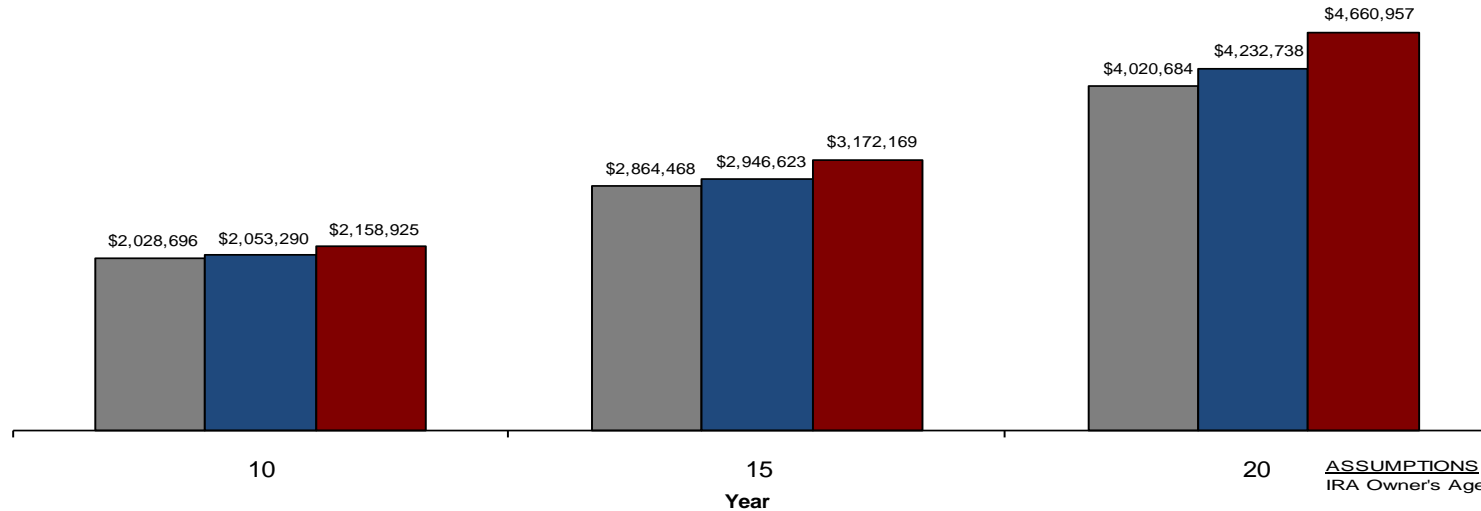
<u>ASSUMPTIONS</u>	
IRA Owner's Age	50
IRA Balance	\$ 1,000,000
Outside Account Balance	\$ 400,000
Yield Rate	2.00%
Growth Rate	6.00%
Total Return (Pre-Tax)	8.00%
Less: Income Tax on Yield @ 40%	-0.80%
Less: Income Tax on Growth @ 20%*	-0.60%
Total Return (After-Tax)	6.60%
Tax Rate - Current Year	30.00%
Tax Rate - Future Years	40.00%

* Assumes 50% annual turnover on growth

Mathematics of Roth IRA Conversions

Example #4 – 70 Year-Old IRA Owner

After-Tax Investment Balance
(Tax Rates Remain the Same)



- Traditional IRA
- Roth IRA Conversion (Pay Tax w/Roth IRA)
- Roth IRA Conversion (Pay Tax w/Outside Account)

ASSUMPTIONS

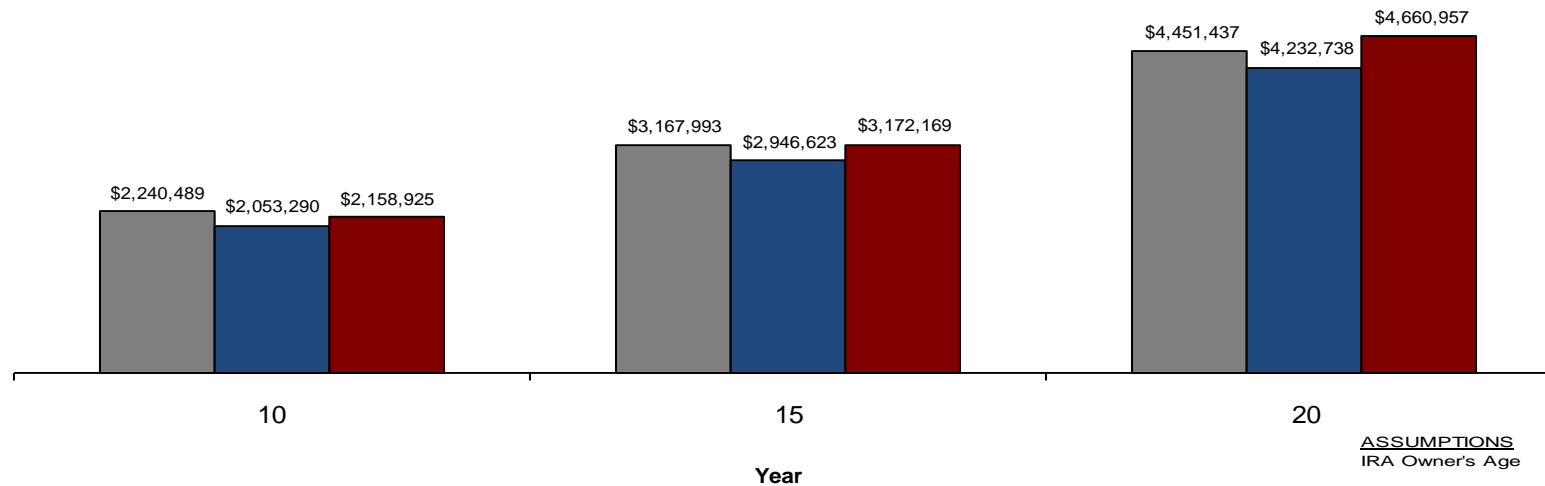
IRA Owner's Age	70
IRA Balance	\$ 1,000,000
Outside Account Balance	\$ 400,000
Yield Rate	2.00%
Growth Rate	6.00%
Total Return (Pre-Tax)	8.00%
Less: Income Tax on Yield @ 40%	-0.80%
Less: Income Tax on Growth @ 20%*	-0.60%
Total Return (After-Tax)	6.60%
Tax Rate - Current Year	40.00%
Tax Rate - Future Years	40.00%

* Assumes 50% annual turnover on growth

Mathematics of Roth IRA Conversions

Example #5 – 70 Year-Old IRA Owner

After-Tax Investment Balance
(Lower Tax Rates in Future Years)



- Traditional IRA
- Roth IRA Conversion (Pay Tax w/Roth IRA)
- Roth IRA Conversion (Pay Tax w/Outside Account)

ASSUMPTIONS

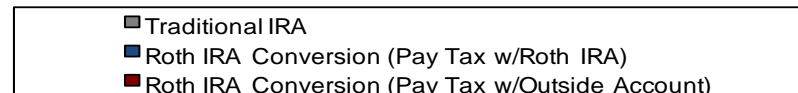
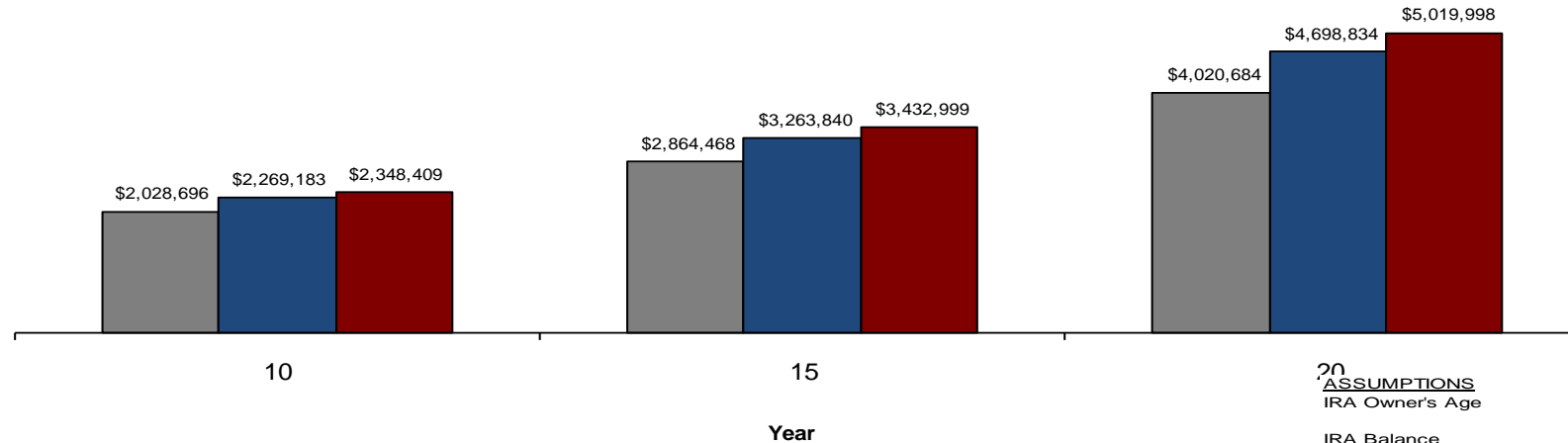
IRA Owner's Age	70
IRA Balance	\$ 1,000,000
Outside Account Balance	\$ 400,000
Yield Rate	2.00%
Growth Rate	6.00%
Total Return (Pre-Tax)	8.00%
Less: Income Tax on Yield @ 40%	-0.80%
Less: Income Tax on Growth @ 20%*	-0.60%
Total Return (After-Tax)	6.60%
Tax Rate - Current Year	40.00%
Tax Rate - Future Years	30.00%

* Assumes 50% annual turnover on growth

Mathematics of Roth IRA Conversions

Example #6 – 70 Year-Old IRA Owner

After-Tax Investment Balance
(Higher Tax Rates in Future Years)



ASSUMPTIONS	
IRA Owner's Age	70
IRA Balance	\$ 1,000,000
Outside Account Balance	\$ 400,000
Yield Rate	2.00%
Growth Rate	6.00%
Total Return (Pre-Tax)	8.00%
Less: Income Tax on Yield @ 40%	-0.80%
Less: Income Tax on Growth @ 20%*	-0.60%
Total Return (After-Tax)	6.60%
Tax Rate - Current Year	30.00%
Tax Rate - Future Years	40.00%

* Assumes 50% annual turnover on growth

Mathematics of Roth IRA Conversions

- Tactical considerations
 - Unused charitable contribution carryovers
 - Current year ordinary losses
 - Net Operating Loss (NOL) carryovers from prior years
 - Alternative Minimum Tax (AMT)
 - Credit carryover
 - Section 199A deduction phase-outs

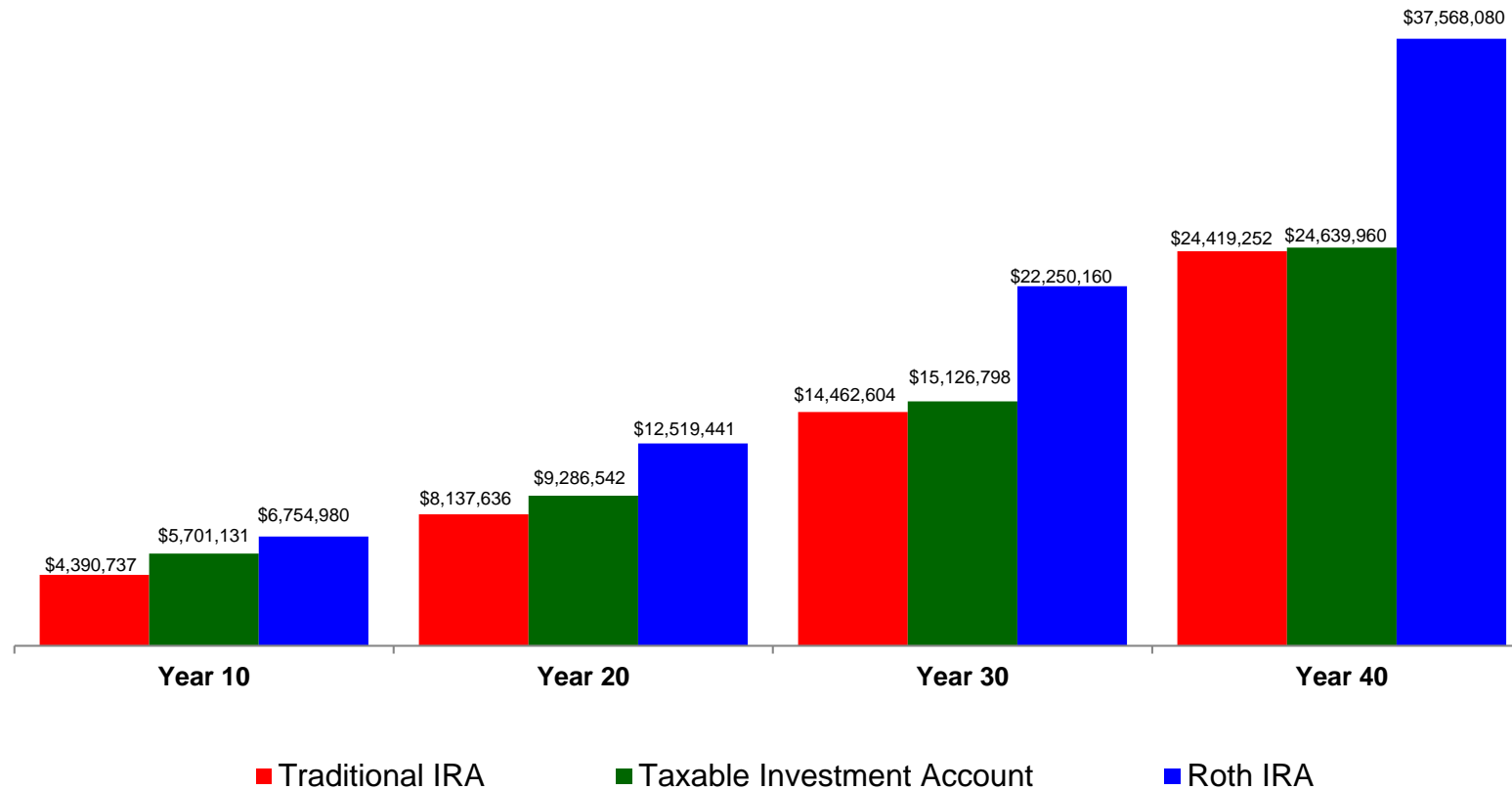
Estate Tax Considerations

Estate Tax Considerations

- Funding the “bypass trust”
 - In funding a decedent IRA owner’s “bypass trust” for estate tax purposes, the primary objective is to fund the trust with assets that have the greatest appreciation potential
 - Although post-mortem Roth IRAs are subject to “required minimum distributions” (“RMDs”), the income tax-free nature of the Roth IRA allows for the greatest amount of wealth to transfer to future generations

Estate Tax Considerations

- Funding the “bypass trust” example



Estate Tax Considerations

- “Missing” IRC § 691(c) deduction
 - When a taxpayer dies with an item of Income in Respect of a Decedent (IRD), such as a traditional IRA, in his/her taxable estate the estate (and/or its beneficiaries) must not only pay estate tax on the IRD but also pay income tax on the IRD
 - To prevent double-taxation of IRD, the federal income tax law allows an income tax deduction (on IRS Form 1040, Schedule A), for federal estate taxes paid on IRD
 - This is typically known as the “IRC § 691(c) deduction”

Estate Tax Considerations

- “Missing” IRC § 691(c) deduction
 - The dilemma with the IRC § 691(c) deduction is that it only is available for federal estate taxes paid on IRD, not state death/estate taxes
 - Thus, the state death/estate tax portion is subject to tax twice (i.e. “missing” IRC § 691(c) deduction)

Estate Tax Considerations

- “Missing” IRC § 691(c) deduction example

	Traditional IRA	Roth IRA
IRA balance	\$ 1,000,000	\$ 1,000,000
Less: Federal and state income taxes on Roth IRA conversion (40%)	-	(400,000)
Taxable Estate	<u>\$ 1,000,000</u>	<u>\$ 600,000</u>
Federal estate tax (40%)	\$ 400,000	\$ 240,000
State death tax (10%)	100,000	60,000
Total estate taxes	<u>\$ 500,000</u>	<u>\$ 300,000</u>
Post-death traditional IRA balance	\$ 1,000,000	
Less: IRC §691(c) deduction	<u>(400,000)</u>	
Post-death traditional IRA balance subject to income tax	\$ 600,000	
Federal and state income taxes on IRA distributions (40%)	\$ 240,000	\$ -
Net IRA balance to beneficiaries	<u>\$ 260,000</u>	<u>\$ 300,000</u>

Estate Tax Considerations

- “Fading” IRC § 691(c) deduction
 - Another dilemma with the IRC § 691(c) deduction is that it is only calculated on the value of the IRD at the time of death
 - Thus, post-death appreciation is not sheltered against income tax by the IRC § 691 deduction, resulting in additional income tax being incurred (i.e. “fading” IRC § 691(c) deduction)

Estate Tax Considerations

- “Fading” IRC § 691(c) deduction example

	No Planning	Roth IRA Conversion at Death
Traditional IRA balance at death	\$ 1,000,000	\$ 1,000,000
Less: IRC §691(c) deduction	-	(400,000)
Taxable portion of Roth IRA conversion	\$ 1,000,000	\$ 600,000
Federal and state income taxes on Roth IRA conversion (40%)	\$ -	\$ 240,000
IRA balance available for future distributions	\$ 1,000,000	\$ 760,000
<hr/>		
Total future IRA distributions	\$ 2,000,000	\$ 1,520,000
Less: IRC §691(c) deduction	(400,000)	-
Less: Amounts not subject to income tax	-	(1,520,000)
Taxable portion of future IRA distributions	\$ 1,600,000	\$ -
Federal and state income taxes on future IRA distributions (40%)	\$ 640,000	\$ -
After-tax total future IRA distributions	\$ 1,360,000	\$ 1,520,000

AICPA PFP Section Member Resources

PFP Section members, inclusive of CPA/PFS credential holders, have access to resources on the latest planning strategies and trends in personal financial planning services so that they can practice competently and profitably. Visit aicpa.org/pfp/resources.



[Estate](#)



[Tax](#)



[Retirement](#)



[Investment](#)



[Insurance &
Risk Management](#)



[Practice
Management](#)



[Legislative/
Regulatory](#)



[Professional
Responsibilities](#)



[Consumer
Content](#)

About the PFP Section & PFS Credential

- The **AICPA Personal Financial Planning (PFP) Section** is the premier provider of information, tools, advocacy and guidance for CPAs who specialize in providing estate, tax, retirement, risk management and/or investment planning advice to individuals, families and business owners. (Learn more at aicpa.org/PFP.)
- The **Personal Financial Specialist (PFS)** program allows CPAs to gain and demonstrate competence and confidence in providing estate, tax, retirement, risk management and/or investment planning advice to individuals, families and business owners through experience, education, examination and the resulting PFS credential. (Learn more at aicpa.org/PFS.)

Disclaimer

This podcast is designed to provide illustrative information with respect to the subject matter covered, and does not represent an official opinion or position of the AICPA or AICPA.Org. It is provided with the understanding that the AICPA and AICPA.Org are not engaged in offering legal, accounting or other professional service. If such advice or expert assistance is required, the services of a competent, professional person should be sought. The AICPA and AICPA.Org make no representations, warranties or guarantees as to, and assume no responsibility for, the content or application of the material contained herein, and especially disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material.



© 2018 Association of International Certified Professional Accountants. All rights reserved.